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DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0733
Gross Income Tax
For The Tax Periods: 1993, 1994, 1995

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ISSUES

I. **Gross Income Tax – Intangibles**

Authority: IC 6-2.1-1-9, 45 IAC 1-1-49, 45 IAC 1-1-17, 45 IAC 1-1-29, 45 IAC 1-1-51, *Department of Revenue v. Mercantile Mortgage Co.*, 412 N.E.2d 1252 (Ind. Ct. App. 1980), *Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992), *Indiana-Kentucky Electric Corporation v. Indiana Department of Revenue*, 598 N.E.2d 647, 662 (Ind. Tax. 1992), *Department of Revenue v. J.C. Penny*, 412 N.E.2d 1246 (Ind. Ct. App. 1980).

The Taxpayer protests the assessment of gross income tax on lease and interest income.

II. **Gross Income Tax – Penalty**

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2(c).

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

The Taxpayer is an out-of-state subsidiary corporation that leases and finances trucks produced by its parent corporation. The Taxpayer provides its customers via independent dealers with financing and leasing options when the customers make their transactions. The Taxpayer maintains one employee in Indiana that works out of his home and is responsible for solicitation in Indiana and neighboring states. The employee has no authority to approve contracts. The

accounting, approval, and collection of the contracts take place out of state. More facts will be supplied as necessary.

I. Gross Income Tax: Intangibles

DISCUSSION

Pursuant to 45 IAC 1-1-17: "'gross income' and 'gross receipts' mean the entire amount of gross income received by a taxpayer. This includes all income actually or constructively received" Here, the income in question is the lease and interest income received by the Taxpayer for financing and leasing equipment that is located in Indiana. Lease and interest income are considered intangibles for gross income tax purposes. Intangible means a personal property right, which exists only in connection to something else. 45 IAC 1-1-51. In general, receipts derived from an intangible are included in gross income. 45 IAC 1-1-51. Thus, these receipts should be included in gross income unless the intangible does not form an *integral* part of a trade or business situated and is not regularly carried on at a *business situs* in Indiana, and the taxpayer's commercial domicile is located outside Indiana. 45 IAC 1-1-51. The Taxpayer is commercially domiciled outside Indiana.

LEASE INCOME

The Taxpayer argues that they do not have a business situs in Indiana . "Business situs" arises where possession and control of a property right have been localized in some business activity away from the owner's domicile. 45 IAC 1-1-49. The Taxpayer cites *Department of Revenue v. Mercantile Mortgage Co.*, 412 N.E.2d 1252 (Ind. Ct. App. 1980) to support their contention. In *Mercantile Mortgage*, the court stated in order to establish a business situs in Indiana, it must be shown that possession and control of the intangibles are localized at the Indiana branch. The Taxpayer argues that the lease income in question has no relation to the leased vehicles delivered in the state and that the customer is not required to keep the leased vehicle in Indiana. They state that the mere passive leasing of vehicles in Indiana is not enough to establish an Indiana business situs. Additionally, the loan application is sent out of state for approval and the interest paid by the customer is made through an out of state office.

However, 45 IAC 1-1-49(6) states that "business situs" may be established by: "[o]wnership, leasing, rental, or other operation of income-producing property (real or personal)." Here, the Taxpayer owns and leases trucks to Indiana customers. Although they argue that they only maintain passive control over the trucks, they only support this claim by stating that the customer may take the truck wherever they desire. Yet, pursuant to a sample lease agreement, the Taxpayer still maintains title or interest in the equipment and the lessee may not modify, assign, or sublet the equipment without the Taxpayer's consent. Also, the equipment may not be used in the transportation of hazardous materials unless the Taxpayer has expressly approved the transportation. This contradicts the Taxpayer's argument that control is merely passive.

Also, the Taxpayer argues that the situation here is very similar to *First National Leasing and Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992). In *First National Leasing*, the Indiana Tax Court held that the income earned by an out-of-state corporation from leasing train derailment equipment to its wholly owned out-of-state subsidiary, who in turn, independently located the equipment in Indiana, was not derived from Indiana

sources. The subsidiary did not make a lease payment to First National Leasing from Indiana. Here, the taxpayer is not leasing to its out-of-state subsidiary, but rather, is the out-of-state subsidiary leasing to its Indiana customers. Therefore, the Taxpayer has not demonstrated absence of a business situs with Indiana.

However, the Taxpayer argues if they are found to have a business situs, there is still no tax situs. Generally, nonresident sellers to Indiana buyers are not subject to gross income unless the "activity was connected with or facilitated the sales [i.e., tax *Indiana-Kentucky Electric Corporation v. Indiana Department of Revenue*, 598 N.E.2d 647, 662 (Ind. Tax. 1992). The Taxpayer surmises that the lease income is not taxable as part of Indiana gross income because it is not an "integral" part of its Indiana activity.

The Taxpayer relies on *Department of Revenue v. J.C. Penny*, 412 N.E.2d 1246 (Ind. Ct. App. 1980). In *J.C. Penny*, the taxpayer was assessed gross income taxes against mail catalog sales and service charges on credit sales. The court stated that: "taxation has been disallowed where the transaction, viewed as a whole, is clearly interstate in character." *Id*. at 1249. Also, "[t]he activities contemplated by the statute must be more than minimal." *Id*. at 1248 (citing *Herff Jones Co. v. State Tax Commissioner*, 247 Or. 404, 430 P.2d 998 (1967)). Here, the Taxpayer's primary business is financing and leasing equipment. Thus, the income in question is directly connected with the leasing and financing of the vehicles in Indiana. Contrary to *J.C. Penney*, the activities that take place in Indiana are more than minimal. Since the equipment that is financed or leased is generally located in Indiana, the lease income represents an integral part of the Taxpayer's Indiana business activities. Thus, the Taxpayer has not demonstrated a lack of business situs or that the lease income is not an integral part of the income derived from its Indiana activities.

The Taxpayer also argues that, assuming the revenue was subject to gross income tax, the receipts are taxable at the lower rate. 45 IAC 1-1-29 states:

> Gross receipts derived from leasing real or personal property are taxable at the higher rate … However, when the leasing agreement is purely a financing device for a sale of tangible personal property and such property is sold in the regular course of business by retail merchant, receipts from the contract are taxable at the lower rate….

During the audit, the auditor found that the Taxpayer did not qualify for "Qualified Lessor" status and was thus taxed using the higher rate. Pursuant to Ind. Code Section 6-2.1-1-9:

> (a) For purposes of this section:
> (1) "Control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of another direct or cause the direction of the management and policies of another entitly, either through the ownership of voting securities, by contract or otherwise.
> (2) "Qualified lessor" means a taxpayer that:
> (A) acquires title to tangible personal property solely for the purpose of leasing it to others;
> (B) has no other purpose of ownership in the property; and

(C) leases the property to another under a lease agreement which has a term of at least five (5) years and which requires the lessee to make rental payments, over the term of the lease, equal to the sum of: (i) the cost of the property, plus (ii) finance charges.

(b) In the case of qualified lessors, "gross income" means gross earnings. For purposes of this section, "gross earnings" includes the excess of the total rental payments received under a lease described in subsection (a), over the cost of the tangible personal property so leased.

(c) For purpose of this section, a taxpayer that in his regular business acquires either a lease agreement described in subsection (a), or the rental payments required under such a lease, is a qualified lessor.

(d) Manufactures or taxpayers engaged in the business of selling, as a distributor or at wholesale or retail or otherwise, the property covered by any lease agreement described in this section is not a qualified lessor.

(e) A taxpayer that directly or indirectly, through one (1) or more intermediaries, controls, is controlled by, or is under common control with, an individual or other organization that manufactures, or is engaged in the business of selling, as a distributor or at wholesale or retail or otherwise, property covered by any lease agreement described in subsection (a), is not a qualified lessor.

The auditor states that the Taxpayer does not meet the requirements set forth in Ind. Code Section 6-2.1-1-9(e). Although the Taxpayer concedes that on its face Ind. Code Section 6-2.1-9 (e) would preclude them from being a qualified lessor. They argue that the situation is different in this case because the Taxpayer purchases the leased vehicles from independent dealer and not from its parent company.

Nevertheless, the statute clearly states that if the taxpayer is controlled by the company that manufactures the property being leased, the taxpayer is not a qualified lessor. Here, the Taxpayer is a wholly owned subsidiary of the company that manufactures the equipment and the Taxpayer's sole purpose is the financing of that equipment. Therefore, the protest of the gross income tax imposed on the lease income must be denied.

INTEREST INCOME

The Taxpayer protest the assessment of gross income tax on interest income earned from retail and wholesale contracts with the independent dealers and their customers. The Taxpayer argues that the interest income should not be taxable to Indiana because it doesn't meet the three-part test for intangibles described above. Although the Taxpayer has a business situs in Indiana, it must be determined whether the interest income is an integral part of the business activity taking place in Indiana.

Similar to *J.C. Penney*, the accounting and collection of the contracts all take place outside the state. Also, the customers make payments directly to the Taxpayer. Indeed, the transactions are interstate in nature and the Indiana activities are minimal. Therefore, the interest income was not an integral part of the business activity carried on at the Indiana business situs.

FINDING

The Taxpayer's protest is sustained in part and denied in part. The Taxpayer's protest on the assessment of gross income tax on interest income is sustained and the protest of gross income on the lease income is denied.

II. **Tax Administration – Penalty**

DISCUSSION

IC 6-8.1-10-2.1(d) allows a penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Also, 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayers must show that they exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. The Department finds that the Taxpayers demonstrated reasonable cause for their failure to pay tax.

FINDING

The Taxpayers' protest of the penalty is sustained.